2011-2012
REVENUE LAWS STUDY COMMITTEE

REPORT TO THE 2011-2012 GENERAL ASSEMBLY OF NORTH CAROLINA 2012 SESSION

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REVENUE LAWS STUDY COMMITTEE
State Legislative Building
Raleigh, North Carolina 27603

Senator Bob Rucho, Co-Chair

Representative Julia C. Howard, Co-Chair
Representative Daniel F. McComas, Co-Chair

May 2, 2012

TO THE MEMBERS OF THE 2012 GENERAL ASSEMBLY:

The Revenue Laws Study Committee submits to you for your consideration its report pursuant to G.S. 120-70.106.

Respectfully Submitted,

_____
Sen. Bob Rucho, Co-Chair

_____
Rep. Julia C. Howard, Co-Chair

_____
Rep. Daniel F. McComas, Co-Chair

2011-2012

REVENUE LAWS STUDY COMMITTEE

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PREFACE

The Revenue Laws Study Committee is established in Article 12L of Chapter 120 of the General Statutes to serve as a permanent legislative commission to review issues relating to taxation and finance. Before it was created as a permanent legislative commission in 1997, the Revenue Laws Study Committee was a subcommittee of the Legislative Research Commission. It has studied the revenue laws every year since 1977. The Committee consists of sixteen members, eight appointed by the President Pro Tempore of the Senate and eight appointed by the Speaker of the House of Representatives.[1] Committee members may be legislators or citizens. The co-chairs for 2011-2012 are Senator Bob Rucho and Representatives Julia Craven Howard and Daniel F. McComas.

In its study of the revenue laws, G.S. 120-70.106 gives the Committee a very broad scope, stating that the Committee "may review the State's revenue laws to determine which laws need clarification, technical amendment, repeal, or other change to make the laws concise, intelligible, easy to administer, and equitable." A copy of Article 12L of Chapter 120 of the General Statutes is included in Appendix A. A committee notebook containing the Committee minutes and all information presented to the Committee is filed in the Legislative Library and may also be accessed online at the Committee's website: http://www.ncleg.net/committees/revenuelaws.

In 2002, the General Assembly established a permanent subcommittee under the Revenue Laws Study Committee to study and examine the property tax system.[2] The

[1] The Speaker of the House of Representatives appointed a ninth legislative member, a non-voting advisory member in 2007, and again in 2009.
[2] S.L. 2002-184, s. 8.

subcommittee consists of eight members, four appointed by the Senate chair of the Revenue Laws Study Committee and four appointed by the House chair of the Committee. The subcommittee may recommend changes in the property tax system to the full Committee for its consideration in its final report to the General Assembly. The Property Tax Subcommittee has not met since 2004.

COMMITTEE PROCEEDINGS

The 2011 General Assembly enacted the Revenue Laws Study Committee's three legislative proposals in whole or in part. Appendix B lists the Committee's recommendations to the 2011 General Assembly and the action it took on them. A document entitled "**2011 Finance Law Changes**" summarizes all of the tax legislation enacted in 2011. It is available in the Legislative Library located in the Legislative Office Building. It may also be viewed on the Legislative Library's website[3] and the Revenue Laws Study Committee's website.[4]

The Revenue Laws Study Committee met eight times after the adjournment of the 2011 Regular Session of the 2011 General Assembly on June 18, 2011. Appendix C contains a copy of the Committee's agenda for each meeting. All of the materials distributed at the meetings may be viewed on the Committee's website. The Committee considered a number of issues, but it ultimately recommended four pieces of legislation. Those proposals are discussed below followed by a summary of the Committee's discussion of the other issues for which no legislative proposal was recommended. The Committee considers all proposed tax changes in light of general principles of tax policy and as part of an examination of the existing tax structure as a whole.

PROPERTY TAX

Questions involving the property tax system, the appeals process for property tax valuations, and the reappraisal methodology have received greater attention recently, and the Committee looked at property tax issues at both the October 5 and the

[3] http://www.ncleg.net/LegLibrary under 'Publications,' 'Tax and Finance Law Changes'
[4] http://www.ncleg.net/committees/revenuelaws

February 1 meeting dates. The Committee heard nine presentations from central staff, the Department of Revenue, the School of Government, and other interested taxpayers and businesses relating to the basics of the Machinery Act and how property tax liability is calculated thereunder, the mechanics of reappraisals by counties, property tax relief programs, valuation of business personal property, and the process by which property tax liability and valuations can be appealed.

In the wake of decreasing home and land values over the past quadrennium, the issue of whether property tax values properly reflect market values of properties has arisen. Property taxes generate $7.8 billion in revenue and account for a significant portion of local revenue. By virtue of the Constitution of this State, the General Assembly classifies property for taxation and must tax uniformly in every unit of local government.[5] The imposition of the property tax involves four activities: listing, assessing, collecting, and enforcing. The standard used to value property is true value or market value as of January 1 of the year of reappraisal. A reappraisal functions to equalize the tax burden between property owners and different property classes. Real property is reappraised no less than once every eight years. While counties have the authority to advance this octennial cycle, the majority of counties choose not to, which can lead to the assessed value as of the listing date diverging from the current market value.[6] Although market value is the default valuation for property tax liability, the General Assembly has enacted a number of property tax relief programs for property

[5] Uniformity requires that exemptions must be the same throughout the State, that the valuation process must be the same for each class of property throughout the State, and that there must be one tax rate for all property within a taxing unit.

[6] Changes in property tax values between reappraisals are permitted, but only for certain grounds. The value can change between reappraisals, e.g., as a result of a physical change (additions, construction, destruction) but not, e.g., as a result of change in the economy or market.

meeting certain ownership and use requirements.[7] Where a taxpayer disagrees with the property tax value assigned, he or she may appeal informally to the assessor, then to the Board of Equalization and Review, then to the Property Tax Commission, and finally to the Court of Appeals and Supreme Court of the State. The number of appeals increases in revaluation years and, generally, has increased sharply since 2007; however, more than 95% of appeals are settled or withdrawn prior to reaching the Property Tax Commission. Costs associated with appeals are low, and taxpayers may represent themselves throughout the process, receiving procedural guidance from the Property Tax Division.

The valuation of certain establishments' business personal property received attention regarding the methodology of appraisal. Generally, personal property is reappraised annually at its true value in money using the cost approach, the sales approach, or the income approach. Representatives of a business presented to the Committee that current Department recommendations were incorrect regarding use of historical cost of business personal property for valuation when the property had been purchased from another owner in an arm's length transaction. The Department presented that business personal property commonly is valued using the cost approach, which takes into consideration original (historical cost), current replacement cost new, useful economic life, and depreciation. Using those factors and trending data, the historical cost is used to reach the cost of the asset in present dollars.

The Committee's review of the property tax valuation methodologies and processes resulted in no recommended changes or legislation.

[7] Notable examples include the exclusion for permanent residences of elderly or disabled taxpayers and veterans; present use valuation for farmlands; and property tax exemptions for property that serves the public interest (such as charitable, literary, educational, scientific, etc.).

SURPLUS LINES INSURANCE

Surplus lines insurance is a line of insurance provided by insurers who are authorized to do business in this State, but who are not licensed in this State, referred to as "nonadmitted insurers." There is a 5% tax on the gross premiums charged for surplus lines insurance.[8] S.L. 2011-120 changed the law governing surplus lines insurers to conform to the federal Nonadmitted and Reinsurance Reform Act of 2010 (NRRA). The federal changes are intended to make the regulation of the surplus lines market more efficient and more uniform on a national basis.[9] However, the Department of Insurance, which is the agency charged with collecting the tax, was concerned before the law took effect that the changes might result in a reduction of surplus lines tax revenues because North Carolina has fewer domiciled companies with multistate exposures compared to many other states. The federal law gives states the option of either keeping 100% of all surplus lines tax collected from premiums paid by domestic companies or sharing tax revenues via a multistate compact. S.L. 2011-120 changed the law, effective July 21, 2011 so that North Carolina now collects 100% of the surplus lines revenue on multistate risks in which North Carolina is considered to be the home state. S.L. 2011-120 also directed the Revenue Laws Study Committee, in cooperation with the Commissioner of Insurance, to study the potential impact of entering into a nonadmitted insurance multistate agreement for the purpose of carrying out the NRRA. Specifically, the Committee was tasked with determining whether entering into a compact would result in retention of surplus lines tax revenue for the State and, if so, which compact or agreement would result in the most retention

[8] G.S. 58-21-85.

[9] Prior to July 21, 2011, surplus lines brokers paid surplus lines taxes to each state where the insured company had covered property in addition to the insured's home state based on the insurance premiums generated in each state. Beginning July 21, 2011, surplus lines brokers are required to pay the home state of the insured all of the surplus lines tax from all of the business that the surplus lines company does around the country.

of surplus lines tax revenue and the most cost-efficient method of administering the collection and distribution of tax revenues.

At its November 5, 2012, meeting, the Committee heard a presentation on this issue from Rose Vaughn-Williams, Legislative Counsel for the Department of Insurance. The presentation was informational so that the members would be prepared to address any policy options that might be recommended by the Department at a later time. Prior to the final meeting, however, the Department reported to committee staff that there is no compact that is currently operational and, therefore, any decision about joining one would be premature. The National Association of Professional Surplus Lines office reports that 28 states have no current plans for participating in tax-sharing arrangements, including states that account for the largest amount of surplus lines tax revenue.[10] The Department further reported that the data currently shows no significant loss to North Carolina on collection of the surplus lines tax from domestic insurers that can be directly attributed to the enactment of the NRRA, which became effective on July 21, 2011. Consequently, the Department recommends that the State take no action at this time. The Department will continue to monitor the tax revenues and will report to the Committee if there is a change.

COMBINED REPORTING AND INTERPRETATION OF TAX LAWS

For more than a decade, the General Assembly has grappled with the laws concerning the taxation of a multistate corporation's income. In North Carolina, a corporation with subsidiaries files a tax return for each subsidiary; this form of reporting is known as separate entity reporting. Under separate entity reporting, a corporation with subsidiaries determines its State net income as if a separate return had

[10] New York, California, and Texas.

been filed for each subsidiary for federal income tax purposes. Separate entity filing gives corporations with subsidiaries in multiple states the ability to devise ways to shift income from a high effective tax rate state to a low effective tax rate state, often through inter-company transactions. The General Assembly has enacted several changes to the State's corporate income tax laws to address the shifting of income between states by multistate corporations.[11] Although several study committees[12], including the Revenue Laws Study Committee[13], recommended the General Assembly consider changing how a corporation determines its net income for corporate income tax purposes from single-entity reporting to mandatory combined reporting[14], the General Assembly never considered the change.

The State has also grappled with the administration of the laws concerning the taxation of a multistate corporation's income. Beginning in the mid-1990s, the Department of Revenue began to more aggressively audit multistate corporations and require them to file a consolidated return when the Department believed the corporation's net income attributable to this State was not accurately reflected on its separate entity return. This action by the Department is referred to as 'forced combination'. The Department has used forced combinations for a number of years and collected more than $200 million in taxes.

Taxpayers, seeking clarity on the law, filed lawsuits contesting the Department's authority to use force combinations. Taxpayers contended that the statutes the Department relied upon to force combinations were vague and that the absence of any

[11] S.L. 2001-327; Section 30G.1 of S.L. 2002-126; Section 24A.3 of S.L. 2006-66.
[12] 2002 Governor's Commission to Modernize State Finances; 2008 State and Local Fiscal Modernization Commission.
[13] 2007 Session, House Bill 462 and Senate Bill 244.
[14] Under mandatory combined reporting, a corporation that is part of an affiliated group engaged in a single trade or business would file a combined report.

guidance from the Department left taxpayers uncertain as to when a combined report was required, who was required to be included in the combined report, or how the combination was to be accomplished. In 2008, the trial court affirmed the Department's assessment based on forced combination of Wal-Mart and several affiliates. The North Carolina Court of Appeals affirmed the trial court's decision in 2009[15] and Wal-Mart chose to settle the case, abandoning its appeal to the Supreme Court.

In 2009, under the auspices of the Wal-Mart decision, the Department began a collection effort known as the "Resolution Initiative." As part of that initiative, the Department imposed significant penalties[16] when a corporation failed to file a combined return, even though G.S. 105-130.14 prohibited a corporation from filing a consolidated or combined return in North Carolina unless specifically directed to do so by the Secretary of Revenue. The Department entered into agreements with at least 130 corporate taxpayers. It appeared some of those taxpayers settled with the Department in order to have the costly penalties waived. In response to this Departmental practice, the General Assembly enacted legislation[17] providing that the Department could not assess penalties for failure to file a combined return unless the Secretary adopted permanent rules describing the specific facts and circumstances under which the Secretary would require a corporation to file a consolidated or combined return.[18] Following the legislative action in the summer of 2010, the Business Court struck down the penalties imposed by the Department on Delhaize,[19] finding that the penalties had

[15] *Wal-Mart Stores East, Inc. v. Hinton*, 197 N.C. App. 30 (2009).
[16] G.S. 105-236 includes a failure to file penalty of 5% to 25%, a failure to pay penalty of 10%, a negligence penalty of 10%, and a large understatement penalty of 25%.
[17] Section 31.10 of S.L. 2010-31. G.S. 105-236(a)(5) and 105-262(b).
[18] The Department of Revenue never adopted rules on this issue.
[19] *Delhaize America Inc. v. Lay*, 06 CVS 08416 (Wake County Superior Court, Jan. 12, 2011).

"significant coercive power" which in these circumstances "violated due process" and exceeded the Secretary's statutory authority.[20]

In the Delhaize case, the Business Court found that the Department worked actively to conceal the standards its decision makers were using when exercising its authority to combine returns. In response to this issue, the General Assembly repealed the statutes[21] that allowed the Secretary to re-determine the net income of a corporation if the Secretary found that a report by the corporation did not reflect its true earnings from its business carried on in this State. In its place, the General Assembly provided that the Secretary may only make this redetermination if the Secretary finds the corporation fails to accurately report its State net income through the use of transactions that lack economic substance or are not at fair market value.[22] The more restricted interpretation became effective for taxable years beginning on or after January 1, 2012. The legislation[23] directed the Revenue Laws Study Committee to recommend whether the law should be made applicable retroactively.

The Revenue Laws Study Committee discussed the issue of retroactivity at its meeting on November 2, 2011. The Committee considered the issues a retroactive effective date may raise: To whom would it apply? What would be its impact on current agreements? Would it result in treating similar taxpayers differently? Would there be unforeseen legal consequences? The Committee chose not to make any recommendation on the retroactive application of G.S. 105-130.5A.

[20] Section 31.10(g) of S.L. 2010-31 specified that the law did not apply to pending cases. In *Delhaize*, the Court found that it would be unjust to impose a penalty on Delhaize when the penalty structure had been amended in 2010 to require the issuance of rules before penalties could be imposed.
[21] G.S. 105-130.6, 105-130.15, and 105-130.16.
[22] G.S. 105-130.5A.
[23] S.L. 2011-390, as amended by S.L. 2011-411.

The Department of Revenue issued the first Corporate Tax Directive[24] it has issued since 2008 on the Secretary's authority to require a corporation to file a combined return. The Department divided the 19-page directive into two parts. The first part concerns tax years beginning prior to January 1, 2012. This part of the directive discusses the Department's interpretation of the law as it applied to taxpayers under G.S. 105-130.6, 105-130.15, and 105-130.16 and appears to set forth the Department's application of the law as upheld by the North Carolina Courts.[25] The second part of the directive sets forth how the Department plans to apply the new law, effective for assessments proposed for taxable years beginning on or after January 1, 2012. The Department described the Directive to the Committee at its November 2, 2011, meeting and presented the Directive to it at the Committee's December 7, 2011, meeting.[26] Representatives on behalf of the North Carolina Chamber of Commerce, the North Carolina Retail Merchants Association, and the Council on State Taxation appeared before the Committee on March 7, 2012, and expressed concern that the Directive issued by the Department did not provide clarity to the law, exceeded the Department's statutory authority, and did not undergo the formal rule-making process.[27]

Throughout the hearings, the Committee expressed strong concerns on the need for the Department to provide clarity on the law for taxpayers and to execute the law as enacted. The Committee began examining the way the Secretary interprets the law at its meeting on March 7, 2012. The tax laws in Chapter 105 of the General Statutes contain

[24] Corporate Income Tax Directives Table of Contents
[25] *Wal-Mart Stores East v. Hinton*, 197 N.C. App. 30 (2009); *Delhaize America, Inc., Plaintiff, v. Kenneth R. Lay*, 2011 NCBC 2: 2011 NCBC LEXIS 9 (2011).
[26] The Department of Revenue later revised its directive and separated it into two directives, published April 19, 2012. CD-12-01 and CD-12-02. See footnote 14 for a link to the bulletins.
[27] North Carolina General Assembly - Revenue Laws > Meeting Documents > 2011-2012 Meeting Documents > March 7

two statutes that appear to give the Department two different pathways of interpreting the law.

Under G.S. 105-264, the Secretary may interpret a law by adopting a rule *or by publishing a bulletin or directive* on the law. The Department has interpreted tax law through the issuance of bulletins[28] or directives[29] since at least 1955. This process does not involve public notice and comment or approval by any outside authority. Bulletins and directives may be issued immediately. A directive or bulletin is not considered a binding interpretation on the courts.

Under G.S. 105-262, the Secretary may adopt rules under Chapter 150B. The Department is exempt from the notice and hearing provisions of Part 2 of Article 2A of Chapter 150B. Although the rule-making process does not provide an opportunity for public notice and hearing for rules adopted by the Department, it does provide a review of the rules by the Rules Review Commission. The Commission reviews rules to ensure they do not exceed an agency's statutory authority. A rule is considered a binding interpretation on the courts. The definition of a rule in G.S. 150B-1 specifically states that a rule does not include nonbinding interpretative statements that merely define, interpret, or explain the meaning of a statute or rule and that a rule does not include statements that set forth criteria or guidelines to be used by the staff of an agency in performing audits, investigations, or inspections.

The Committee expressed a strong desire for the Department to provide guidance through the rulemaking process, especially on the issue of forced

[28] Bulletins present the Department of Revenue's administrative interpretation and application of tax laws. The Department has 'Corporate, Excise, and Insurance Tax Bulletins', 'Individual Income Tax Bulletins', and 'Sales and Use Tax Bulletins'. The Department typically updates the bulletins annually to reflect changes in the law or administrative interpretation. However, the Department has not updated the bulletins in the last three or four years.

[29] Directives are issued by the Department of Revenue on an as-needed basis to interpret a tax law, explain the application of law to stated facts, or to clarify an issue on which the Department has received numerous questions. Directives are not updated to reflect changes in the law or administrative interpretation. The contents of a directive may be included in an updated bulletin.

combinations. The Department voiced strong concerns about its ability to effectively and efficiently administer the tax laws if it had to undertake rulemaking for all of the guidance it provided. In the debate, the Committee identified three goals:

- The need for taxpayer certainty about the tax laws.
- The need for an outside determination as to whether the Department has exceeded its statutory authority in its interpretation of the law.
- The opportunity for public notice and comment on the Department's interpretation of the law.

Legislative Proposal #1, seeks to balance these three goals. It requires the Secretary to adopt rules providing guidance to taxpayers on its administration of G.S. 105-130.5A, the newly enacted law regarding the Secretary's ability to re-determine a corporation's State net taxable income by adjustment or by forced combination. The Committee plans to give further consideration during the next interim as to whether the Secretary must adopt rules providing guidance on its administration in other tax areas.

To expedite the rulemaking process, the *Legislative Proposal #1* does the following:

- It provides the rulemaking procedure will be the quicker timetable allowed for temporary rulemaking. This process allows 15 days for notice and comment from outside parties. Anyone may object to a proposed or adopted rule by requesting review by the Rules Review Commission. If no one requests review by the Rules Review Commission, the adopted rule may be delivered to the Codifier of Rules and entered into the Code. If the Department receives written objections to the rule and requests that the rule be reviewed, then the Rules Review Commission must review the rule within 15 days. The Commission may not extend the period of time for review.

- It changes the fiscal note requirement to allow Revenue to prepare its own fiscal note.[30] It will not need to submit the fiscal note to OSBM. The fiscal note must be submitted with the proposed rule to the Codifier of Rules and posted on the Internet. A person may comment on the fiscal note in the same manner a person may comment on a proposed rule.[31]
- It exempts the Department from the delayed effective date provisions that apply whenever the Commission receives 10 or more objections to a rule requesting review by the legislature.

Appendix ___ contains a chart that summarizes the procedure outlined in *Legislative Proposal #1.*

NORTH CAROLINA ESTATE TAX

In 2001, all 50 states and the District of Columbia imposed an estate tax when an individual died on the value of the individual's accumulated assets.[32] In 2012, North Carolina, 21 other states, and the District of Columbia impose an estate tax. The Committee heard presentations by groups seeking the repeal of NC's estate tax and groups supporting the estate tax during meetings held January 4, 2012 and March 7, 2012.

For decedents dying in 2012, North Carolina imposes an estate tax on the value of the estate over $5 million. The tax rate is graduated from 0.8% to a maximum rate of

[30] A fiscal note must be prepared if the rule has a substantial economic impact. Prior to 2011, the term 'substantial economic impact' meant a cumulative impact of $3,000,000. In 2011, this amount was reduced to $500,000.

[31] The proposal provides that the Department does not need to provide a fiscal note for a proposed rule it publishes before December 31, 2012. See Section 4 of the proposal.

[32] The State's largest tax schedules are based on income taxed on a yearly basis (i.e., individual income tax and corporate income tax) and consumption taxed at the time of sale or use (i.e., sales and use tax). The estate tax is a tax on past economic activity, and the larger tax schedules are taxes based on ongoing economic activity.

16% for taxable estates over $10,040,000. Among the states imposing an estate tax, North Carolina allows the largest exemption at $5 million. For the 2009-2010 fiscal year, the NC estate tax represented 0.39% of General Fund tax revenue.[33]

The federal estate tax dates to 1797 and was historically imposed by the federal government to fund wars. In modern times, the NC estate tax has followed the federal estate tax in exemption amounts and definition of the tax base. The federal estate tax laws have changed yearly since 2001.

In 2001, the federal estate tax was designed as a revenue sharing system where the federal estate tax gave estates a 100% credit for state estate tax.[34] Because estates received a full credit for state estate tax imposed, the estates did not pay any additional estate tax if state estate tax also applied.

In 2012, the federal estate tax allows only a deduction for state estate tax.[35] Because the deduction did not relieve estates of the financial loss of paying state estate tax, estates do pay additional estate tax if state estate tax applies. The federal estate tax is scheduled to return to the 2001 law with a $1 million federal exemption for decedents dying after December 31, 2012. In 2013 and later years, federal law again allows the 100% credit for state estate tax.

Assuming that federal law does not change, repealing the NC estate tax would not benefit NC estates in 2013 and later years because the credit for state estate tax

[33] The NC estate tax collected over $100 million in General Fund tax revenue in fiscal years 2001-2009. North Carolina followed federal law and did not impose an estate tax in the calendar year 2010. Collections from the NC estate tax are projected to return to $92 million during the 2012-2013 fiscal year, as collections recover from the lapse of the estate tax in 2010.

[34] A tax credit offsets a tax liability dollar for dollar (i.e., by the same amount). For example, a $1 credit relieves a taxpayer of $1 in tax making a tax credit worth the same dollar amount as the credit.

[35] A tax deduction offsets income subject to tax (i.e., reduces the amount of income multiplied by a tax rate). For example, assuming a 16% tax rate, a $1 deduction relieves a taxpayer of $0.16 in tax making a tax deduction worth the tax rate multiplied by the dollar amount of the deduction.

offsets federal estate tax - resulting in the same total estate tax due with or without a state estate tax.

The Committee did not make any legislative recommendations related to this topic.

UNEMPLOYMENT INSURANCE PROGRAM

The State Unemployment Trust Fund (Trust Fund) provides benefits to people who have lost their jobs through no fault of their own. The revenues for the Fund come from the imposition of payroll taxes, commonly called "contributions", on employers. North Carolina's unemployment tax (SUTA) rate varies from 0% to 6.84% based upon the employer's experience rating and is imposed on wages up to $20,400[36] for the 2012 taxable year. The contributions paid by employers to the Trust Fund may only be used to pay claimant benefits. In addition to the payroll tax, the State imposes a tax on contributions at the rate of 20% of the contributions due in any calendar year when the Employment Security Reserve Fund does not equal or exceed $163,349.000.[37] The revenue from this tax is credited to the Reserve Fund and its use is not restricted.

In addition to the SUTA, employers pay a federal unemployment tax (FUTA). The FUTA tax rate is 6% and is imposed on wages up to $7,000 a year. Federal law provides a credit against the tax liability of up to 5.4% to employers who pay state taxes timely under an approved state unemployment insurance program. The credit against the federal tax may be reduced if the state has an outstanding loan. When states lack the funds to pay unemployment insurance benefits, they may obtain a loan, or an "advance", from the federal government. To assure the loans are repaid, federal law provides that when a state has an outstanding loan balance on January 1 for two

[36] This amount is indexed annually.

[37] G.S. 96-9(b)(3)j. The Reserve Fund has fallen below this amount since the 2005 calendar year.

consecutive years, the full amount of the loan must be repaid before November 10 of the second year or the credit available to employers will be reduced 0.3% a year until the loan is repaid.

North Carolina received its first advance from the federal treasury to finance the benefits payable from the Trust Fund in February 2009.[38] Interest did not begin accruing on the loan until January 1, 2011, because Congress waived interest payments due from states on any advances through December 31, 2010.[39] North Carolina paid its first interest payment of $78.8 million on an outstanding loan amount of $2.5 billion in September 2011. The State made the interest payment from funds available in the Employment Security Reserve Fund. The State needed to repay the loan amount by November 2011 to avoid a FUTA credit reduction of 0.3%, which it was unable to do. The effective FUTA tax rate for North Carolina employers for the 2012 calendar year increased from 0.6% to 0.9%. The increase equals approximately $21 per employee for a FUTA tax rate of approximately $63 per employee.

The choice North Carolina will have to make is not whether the unemployment insurance tax rate employers pay will increase but rather what is the optimal way to address the State's unemployment insurance issues while minimizing the impact on job growth and unemployed workers. The General Assembly enacted Senate Bill 99 this past session.[40] Senate Bill 99 directed the Department of Commerce to contract with an independent consulting firm specializing in unemployment insurance and employment security reform. The purpose of the contract is to obtain recommendations on what tax structure changes would be fair to employers and how these revenues and other

[38] As of March 29, 2012, North Carolina has an outstanding loan balance of $2.8 billion. Thirty states have an outstanding loan from the Federal Unemployment Account. Only three states have a larger loan balance than North Carolina: California, New York, and Pennsylvania.
[39] American Recovery and Reinvestment Act of 2009, P. L. 111-5, approved February 17, 2009.
[40] S.L. 2011-10.

financial options might be used in servicing and liquidating the State debt incurred to pay unemployment insurance benefits. The act exempted Commerce from the purchase and contract requirements in regards to this consulting contract in an attempt to expedite the study. Although Senate Bill 99 became law on March 25, 2011, the contract had not been let by December 2011.

The Revenue Laws Study Committee asked the Department of Commerce to appear before it and give a status report on both the consulting contract and the merger of the Employment Security Commission with the Department of Commerce.[41] Dale Carroll, the Deputy Secretary of Commerce, appeared before the Committee on December 7, 2011, and discussed the merger objectives and implementation. He also explained that the RFP bidding process was complete for the unemployment insurance tax reform consulting contract and the Department was reviewing the bids and the process. The Committee again looked at these issues on January 4, 2012. It subpoenaed Lynn Holmes, the former Commissioner of the Employment Security Commission and the Assistant Secretary of the Employment Security Division of the Department of Commerce[42], to appear before the Committee at its January meeting. A transcript of her testimony before the Committee is available on the Committee's website.[43]

After the adjournment of the 2011 Session of the General Assembly, events continued to unfold in the area of unemployment insurance law that will require action by the 2012 Session of the General Assembly. The actions required by the General Assembly in this area do not fall within the matters that may be considered as stand-

[41] S.L. 2011-145 (House Bill 200), Section 14.5 and Section 14.5C, and S.L. 2011-401 (Senate Bill 532), transferred ESC to the Department of Commerce and directed the Department to enter into a contract related to employment security organizational reform.

[42] Lynn Holmes resigned as the Assistant Secretary of the Division of Employment Security, effective April 15, 2012. The Governor named Dempsey Benton as the new Assistant Secretary.

[43] North Carolina General Assembly - Revenue Laws > Meeting Documents > 2011-2012 Meeting Documents > January 4

alone bills introduced in the 2012 Session, as outlined in Section 4.2 of Resolution 2011-12.[44] Although some of the issues that need to be addressed in the 2012 Session fall outside the usual parameters of the Revenue Laws Study Committee, this study committee appears to be the only joint legislative committee that has the necessary background to consider the issues and make a possible recommendation on these issues to the 2012 General Assembly.

The issues the General Assembly may wish to consider in the 2012 Session in the area of unemployment insurance law fall largely into three categories:

- The extension of the three-year look-back period from January 1, 2012, to January 1, 2013.
- The resolution of outstanding issues from Senate Bill 532, S.L. 2011-401.
- The statutory changes to the unemployment insurance laws required by the Trade Adjustment Assistance Extension Act of 2011.[45] .
- *Extended Benefits.* – There are two permanent benefit programs required by federal law: regular unemployment benefits and extended benefits.[46] Regular unemployment benefits are fully funded by the State through its State Unemployment Insurance Trust Fund and claimants in North Carolina are eligible to receive benefits for up to 26 weeks under it. Extended benefits are available in a state when the state is experiencing high levels of unemployment.[47] The program is funded 50% by state contributions and 50% by the federal government. However, the federal government has paid 100%

[44] http://ncleg.net/Sessions/2011/Bills/Senate/PDF/S793v2.pdf
[45] P.L. 112-40, approved October 21, 2011.
[46] Congress enacted Emergency Unemployment Compensation in 2008, known as EUC08. These benefits are fully payable by the federal treasury.
[47] In North Carolina, a claimant may receive up to 20 weeks of extended benefits.

of the extended benefit claims since February 22, 2009.[48] Under the Middle Class Tax Relief and Job Creation Act of 2012[49], the federal government will continue to pay 100% of the extended benefits through December 31, 2012.

- Extended benefits are triggered in a state when the unemployment rate is at least 6.5% and at least 10% higher than it was at the same time in either of the past two calendar years; this two-year window is known as the "two-year look-back". In the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010[50], Congress allowed states to amend their laws to temporarily increase the two-year look-back period to a three-year look-back period. This measure enabled more states to offer extended benefits. Under the 2010 legislation, the temporary measure ended December 31, 2011. However, Congress extended the temporary measure twice.[51] The full federal funding of the extended benefits will expire December 31, 2012.

North Carolina changed the law to permit a three-year look-back in S.L. 2011-145, Section 6.16. This provision expired January 1, 2012. *Legislative Proposal #2* would extend the sunset from January 1, 2012, until January 1, 2013. In North Carolina, extended benefits will not be allowed for claim weeks later than May 12, 2012, because the State's unemployment rate has fallen below the trigger. However, it is possible the extended benefits may trigger back "on" before the end of the year.

The Governor ordered the Employment Security Commission to use the three-year look-back in Executive Order 93, dated June 3, 2011. The Governor ordered the

[48] P.L. 111-5, Sec. 2005, approved February 19, 2009, *American Recovery and Reinvestment Act of 2009*. The provision has been extended several times in other federal legislation.
[49] P.L. 112-96, approved February 22, 2012.
[50] P.L.111-312, approved December 17, 2010.
[51] P.L. 112-78, approved December 23, 2011, *Temporary Payroll Tax Cut Continuation Act of 2011.* P.L. 112-96, approved February 22, 2012, *The Middle Class Tax Relief and Job Creation Act of 2012.*

Division of Employment Security to use the three-year look-back in Executive Order 113, dated January 11, 2012. Although the Executive Orders purport to give the Governor the authority to make this change, the federal law clearly states that a "State may by law" provide for the temporary look-back extension.[52] *Legislative Proposal #2*, finds that the Governor did not have the authority under federal law, the North Carolina Constitution, or Chapter 96 of the North Carolina General Statutes to change the look-back period.

Outstanding Issues Re: S.L. 2011-401. – The General Assembly enacted Senate Bill 532 on July 26, 2012.[53] Senate Bill 532 had four operative parts:

- It created the Division of Employment Security within the Department of Commerce and transferred the functions of the Employment Security Commission to that Division.
- It made the Division subject to rulemaking under Article 2A of chapter 150B of the General Statutes.
- It made substantive changes to the employment security laws.
- It made conforming changes to the employment security laws.

On June 30, 2011, the Governor vetoed the bill. In the Governor's Objections and Veto Message, she stated the U.S. Department of Labor informed the administration that a lack of conformity between the bill and federal law could result in a loss of money for the State's unemployment insurance program and a reduction in the FUTA tax credit. A state's law must conform to the provisions of the federal unemployment compensation laws in order for employers in a state to be eligible for a credit against the

[52] P. L. 11-312, approved December 2010, Sec. 502, *Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.*
A state's law must conform to the provisions of the federal unemployment compensation laws in order for employers in a state to be eligible for a credit against the FUTA tax and for the state to be eligible to receive an administrative grant to operate its unemployment compensation programs. [53] S.L. 2011-401.

FUTA tax and for the state to be eligible to receive an administrative grant to operate its unemployment compensation programs.

The General Assembly overrode the Governor's veto on July 26, 2011. After passage of the bill, the Employment Security Commission informed the General Assembly by a letter dated October 12, 2011, of its intention to suspend the provisions of the bill determined by the U.S. Department of Labor to be noncompliant with federal law. G.S. 96-19(b) gives the Division of Employment Security the authority to suspend enforcement of a provision upon receiving notification from the U.S. Department of Labor that the provision is noncompliant with the requirements of federal law. The suspension may be in effect until the Legislature next has an opportunity to reconsider the provisions purported to be noncompliant with federal law.

Legislative Proposal #2 addresses the areas of concern noted by the U.S. Department of Labor:

- The legislation expanded the time for an employer to provide information required to protest a claim from 10 days to 30 days. The U.S. Department of Labor noted that the extension of time would make it virtually impossible for the agency to make timely determinations under the standards set by federal regulations.[54]
- An individual is totally disqualified from receiving benefits if the Division of Employment Security determines the individual was discharged for misconduct connected with the work. The legislation expanded the definition of "misconduct connected with the work" to include both of the following:

[54] For most intrastate claims, federal regulations require that a state pay at least 87% of its claims within 14 days of the end of the first compensable week, or 21 days for states that do not have a waiting week requirement, and 93% of such claims within 35 days.

- Arrest for or conviction of certain offenses. The U.S. Department of Labor noted that the new definition did not require that the criminal conduct be connected with the individual's work.
- Failure to adequately perform employment duties after being warned. The U.S. Department of Labor noted that, in order to be the basis for a disqualification to receive unemployment benefits, unsatisfactory job performance must be the result of intentional behavior or gross negligence, and must be egregious.

- The legislation allowed the parties to tender stipulation of the ultimate issues in cases pending on appeal to the agency. The U.S. Department of Labor noted that while a stipulation of facts might be acceptable, a stipulation of the issues vitiates the agency's federally-mandated responsibility to apply the unemployment law to specific facts. The Department also recommended that any procedure or process by which an appeals referee or hearing officer accepts a stipulation of fact should be recorded.

Senate Bill 532 created a Board of Review[55] to determine appeals policies and procedures and to hear appeals arising from the decisions and determinations of the Employment Security Section and the Employment Insurance Section. The annual salaries of the three-person board are to be set by the General Assembly in the current Operations Appropriations Act. The Current Operations and Capital Improvements Appropriations Act of 2011 did not set the salaries for the members of the Board of Review. *Legislative Proposal #2* provides that the current Operations Appropriations Act of 2012 must provide for the annual salaries of the Board of Review, as provided in G.S. 96-4(b).

[55] G.S. 96-4(b).

Conformity to the Trade Adjustment Assistance Extension Act of 2011. – In 2002, the United States General Accounting Office issued a report on the unemployment insurance program and the need for an increased focus on program integrity. The focus of President Obama's Executive Order 13520, issued November 23, 2009, was the reduction of improper payments in major programs administered by the federal government, including the unemployment insurance program. In response to the level of improper payments in the unemployment insurance program, the U.S. Department of Labor developed a strategic plan to address the root causes of improper payments. The plan involves new performance measures for the states; increased funding of new tools and technology; and a focus on the root causes leading to improper payments. The three identified root causes leading to improper payments are:

- Claimants continuing to claim benefits after returning to work.
- Untimely and insufficient separation information from employers and third party administrators.
- A gap in employment service registration.

As part of the increased focus on program integrity, the U.S. Department of Labor recommended legislative language to Congress in June of 2011. In October 2011, three key integrity provisions recommended by the Department were enacted as part of the Trade Adjustment Assistance Extension Act of 2011. *Legislative Proposal #2* includes the statutory change the State must make to be in conformity with federal law this year. The proposal does not include the other two changes because they do not need to be in place before October 21, 2013. The three program integrity provisions are as follows:

- New Hire Directory. – To address the gap in employment service registration, the federal law requires states to expand the definition of a 'newly hired employee' to include a rehired employee who was separated for at least 60

days. It also requires employers to enter the start date of employment when the employer submits the information to the New Hire Directory. The New Hire Directory was created years ago to assist states with the collection of child support payments. The Directory is administered by the Department of Health and Human Services. The directory is also a valuable tool for unemployment insurance programs because it allows the agency to cross-check claimants with new hires. This information assists the agency with the detection of overpayments being made to individuals who have returned to work. States are required to make the necessary statutory changes to its New Hire Directory within two months after the latest legislative session ends. *Legislative Proposal #2* includes the necessary changes.

- Prohibition on Non-Charging of Employer Accounts. – To address the untimely and insufficient separation information provided by employers and third party administrators to the agencies, the federal law requires states to enact a provision prohibiting the non-charging of employer's unemployment insurance account when an improper payment is made because of the employer's failure to respond timely or adequately to a written request for separation information. In most states, an employer's state unemployment tax rate is based upon an experience rating whereby employers that have more claims or charges against their unemployment insurance account have a higher tax rate. Under current law, benefits paid to a claimant erroneously may not be charged to the employer's account if the erroneous payment is made because the employer failed to respond timely and adequately to the agency. This provision points to a trend whereby employers are expected to improve the quality of information provided to state employment agencies at

the front end of the UI claim process, rather than waiting until a hearing to provide details. Although a state may impose a stricter standard, it must impose the minimal federal standard by October 21, 2013. *Legislative Proposal* #2 does not include this change because it is not required to be made until October 2013.

- Monetary Penalty Assessment. – To address claimants who fraudulently continue to accept unemployment benefits after returning to work, the federal law requires states to impose a penalty on the claimant equal to 15% of the amount of erroneous overpayment if the agency determines that the overpayment is due to fraud. Under G.S. 96-18(a), a fraudulent overpayment is one that results from a person's false statement or representation *knowing* it to be false or from a person *knowingly* failing to disclose a material fact to obtain or increase a benefit received. The money collected from the penalty is payable to the State Unemployment Trust Fund and its use is limited to the payment of unemployment compensation benefits. States may enact a larger penalty amount and may use the additional amount for whatever purpose it desires. The 15% federally mandatory penalty must be in place by October 21, 2013. *Legislative Proposal* #2 does not include this change because it is not required to be made until October 2013.

PRIVILEGE TAX

At its February 12, 2012, meeting, Christopher McLaughlin, Assistant Professor of Public Law and Government at the UNC School of Government, provided the Committee with an overview of the local privilege license tax system and an analysis of its deficiencies. The issues associated with the privilege license tax are not new to this

Committee. The Committee previously studied this system of taxation in 2004[56] and 2008,[57] but it has yet to make any recommendations. Historically, this system of taxation has been considered an outmoded, inefficient, and arbitrary method of raising revenue largely because it places a tax burden on a limited number of businesses. It was for these reasons that the vast majority of State privilege license taxes were repealed in 1997. At the time, the prevailing thought was that changes to the local privilege tax system would soon follow, but the General Assembly has not been able to reach any consensus about what changes should be made.

Through Mr. McLaughlin's presentation, the Committee heard once again how the system is archaic, inconsistent, and arbitrary. The system is archaic because it is based on references to repealed statutes, which are essentially "trapped in time" and cannot be changed. Specifically, the repealed statutes refer to monetary caps that have never been adjusted for inflation and to businesses that sell items like record players, tape cartridges, and bagatelle tables. The Committee heard that the law is often applied inconsistently because local business license officers have different, yet valid, interpretations of how to apply the repealed statutes. The system is arbitrary because there is no rationale for exempting some businesses altogether, subjecting some to caps, and subjecting others to an unlimited amount of tax. Given these characteristics, the administration of privilege license taxes frequently proves to be a source of confusion for local governments and taxpayers alike.

When this Committee last looked at privilege license taxes, the specific concern raised by taxpayers at the time had to do with double taxation. This year, a number of businesses have raised a concern about the absence of a statutory restriction on the

[56] February 3, 2004.
[57] November 19, 2008.

amount of tax that a city may levy, particularly in those cities that have opted to levy a privilege license tax based on a business' gross receipts. Other than the types of businesses that are subject to a flat rate or cap under the repealed Schedule B, there is no statutory limitation on the amount of tax that a city may levy upon a business. In Durham, for example, the tax is $50 for retailers with up to $15,000 in gross receipts, then $0.50 per each additional $1,000 in gross receipts with no maximum. A Durham business with $50 million in gross receipts would pay a privilege tax of $25,000. The City of Charlotte has a cap on its tax, but it was recently raised from $2,000 to $10,000. In fact, Charlotte is among the highest in terms of annual revenue generated by this tax, bringing in close to $25 million in FY 2009-2010. With regard to the amount of tax, Mr. McLaughlin pointed out that the North Carolina Constitution provides that taxes must be "fair and equitable" but, generally speaking, the courts have given taxing authorities broad discretion in this area.[58] He also discussed apportionment problems that exist for businesses operating in multiple cities. That is, it can be difficult for a business to determine its gross receipts derived from a particular city for purposes of paying the privilege tax when that business may be headquartered in one city but provides services to customers in another city or multiple cities.

With regard to public remarks on this subject, the Committee heard from Andy Ellen with the Retail Merchants Association, Jim Ahler with the North Carolina Association of CPAs (Association), and Kelli Kukura with the League of Municipalities. Mr. Ellen agreed with the concerns illustrated in Mr. McLaughlin's presentation. Specifically, he provided the Committee with an example of an independent grocery

[58] In late February, the North Carolina Court of Appeals ruled in favor of the City of Lumberton regarding its authority to levy substantial privilege license taxes on internet sweepstakes businesses. In that case, four sweepstakes operators sued the city for taxing each business $5,000 per location and $2,500 per terminal. This case may be heard by the North Carolina Supreme Court, and the door is still open for a ruling on the *amount* of taxes that may be levied.

store owner whose privilege license tax went from $50 in 2009 to nearly $6,000 in 2010 because the city adopted a gross receipts schedule. Mr. Ellen also voiced the taxpayer's concern that the gross receipts method of taxation disproportionately impacts a business operating on a low profit margin.

Mr. Ahler provided the Committee with information related to efforts by the City of Charlotte to impose a local privilege license tax on CPA firms licensed by the State Board of Certified Public Accountant Examiners (Board) based upon its assertion that some consulting services offered by licensed CPA firms do not constitute accounting services and, therefore, are a separate, taxable activity. Mr. Ahler relayed that the Association does not share the City's view about the liability of CPA firms for local privilege license taxes. The Association's position, rather, is that the State's authority to levy a State privilege tax on the accounting profession is exclusive, and, therefore, the City exceeded its authority in levying the local tax.

Under G.S. 105-41, the State imposes a flat privilege license tax on persons engaged in the public practice of accounting and prohibits counties or cities from levying a license tax on this profession. Mr. Ahler pointed out that there is no mention of "separate activities" under the State statute and that consulting clearly falls within the purview of public accountancy as defined and regulated by the Board. In a subsequent communication to the Association from the City, Assistant City Attorney Thomas Powers stated that as long as a business is a CPA firm, is registered with the NC State Board of CPA Examiners as a CPA firm, and is registered with the Secretary of State as an accounting or consulting services type of business, the business is exempt from local privilege tax. These requirements do not, however, appear in G.S. 105-41. As of the date of this report, it is the Committee's understanding that the City of Charlotte is not currently pursuing licensed CPA firms that are registered with the Board for local

privilege license tax, but acknowledges the interpretational issues raised by the Association.

Finally, the Committee heard remarks from Kelli Kukura with the North Carolina League of Municipalities. Ms. Kukura informed the Committee that one of the primary benefits of the privilege tax system is that it provides a gateway for businesses. Since all businesses must obtain a license, contact with a local business license office serves as a centralized source to inform owners of the various legal requirements and other general information related to their business. However, Ms. Kukura acknowledged that the system is flawed and was in general agreement with the comments expressed at the meeting. To that end, she conveyed the League's position that it will support legislation to reform the privilege license tax by 1) eliminating exemptions and caps for specific categories of businesses; 2) specifying the appropriate bases for the tax; 3) requiring municipalities to adopt a rate schedule that applies to all types of businesses within a municipality; 4) limiting the amount of taxes paid by businesses that have business activity within a municipality but no business location within it; 5) capping the amount of tax that can be imposed on any single business location.

The Committee concluded that the system needs to be improved in the areas of transparency, consistency, and simplicity, but it did not recommend specific changes. However, to the extent that a number of references have been made this interim to anticipated efforts at broad modernization of the overall tax structure in 2013, it is possible that changes to the local privilege tax system could be a component of that reform.

TAXATION OF SOLAR ELECTRICITY EQUIPMENT

Advances in solar energy equipment manufacturing combined with State and federal tax incentives for the equipment have allowed the production of solar energy to be cost effective and have increased demand for solar energy equipment. Due to this growing interest in solar energy, the Department of Revenue has received many questions regarding the tax treatment of solar energy equipment. The Department of Revenue provided an overview of this issue at the March 7, 2012 Revenue Laws meeting.

Sales of personal property are generally subject to the sales and use tax. However, purchases of personal property for manufacturing are subject to a privilege tax under Article 5F of Chapter 105 of the General Statutes. The rate of the privilege tax is 1% of the sales price of the property, with a cap of $80. Questions have arisen as to whether solar energy equipment should be subject to the sales tax, or the privilege tax on manufacturing property.

The Department has issued a Sales and Use Tax Bulletin that provides sales of tangible personal property by "firms engaged in generating, producing or processing electric power to be distributed to consumers" are subject the privilege tax on manufacturing equipment, and therefore, not subject to the sales tax. The tax treatment of the solar energy equipment depends on whether the purchaser of the equipment is engaged in generating electric power, and whether the electricity generated is distributed to customers. Differences in how the equipment is connected to the electric grid can lead to a significant difference in tax liability for identical solar energy equipment.

Legislation could be proposed to clarify the issue, either providing all solar energy equipment should be subject to the privilege tax on manufacturing equipment,

or providing that only solar energy equipment sold to electric power companies directly engaged in sales of electricity to consumers is subject to the privilege tax on manufacturing equipment. The Committee did not recommend any changes at this time.

SALES TAX AND PERFORMANCE CONTRACTORS

At its March 7, 2012, meeting, the Committee heard a presentation from Canaan Huie, General Counsel for the Department of Revenue, regarding the sales and use tax treatment of performance contracts. This is a complex area of sales tax law that has created confusion for many years. The issue centers on how to determine whether a certain transaction is a retail sale plus installation or a performance contract for purposes of applying the sales and use tax. Under current law, retailers are required to collect and remit sales tax on retail sales of tangible personal property, but sales tax is not collected from a customer who enters into a performance contract. Under a performance contract, the contractor agrees to furnish the necessary materials, labor, and expertise to accomplish the job; it is not a contract for the sale of specific items. Contractors are deemed to be the consumers or end-users of the tangible personal property they use in fulfilling performance contracts and, as such, are liable for payment of the applicable tax. The tax may not be added to the agreed-upon contract price as a separate charge on the invoice, but it must be included in the computation of the cost of the materials necessary to perform the contract.

While these rules may seem straightforward, there are a number of gray areas to the extent a transaction involves the provision of both tangible personal property and services. Specifically, a retailer may sell tangible personal property and also offer installation of that property, such as major appliances or high-end entertainment equipment. Generally speaking, retailers must collect sales tax on the property, but the

installation services are exempt from sales tax as long as those services are separately stated on the invoice at the time of sale. Conversely, a customer who enters into a performance contract does not owe sales tax on the property used to fulfill that contract, but rather the contractor owes sales or use tax on those items. A clear example of a performance contract would be a contract for the painting of a house or for cleaning services. The customer would not pay sales tax on the paint or the cleaning products used to complete those services.

The interpretation problems most often arise with "retailer-contractors," like the major home improvement stores, that perform the installation of major fixtures, such as cabinetry and carpeting. Over time, the Department has developed guidance through its technical bulletins, and the tax treatment is ultimately determined by looking at a number of factors, such as whether an item is sold with an installation agreement, the tenor of the agreement, if there is one, whether an item is pre-fabricated, whether an item is built on-site, and whether a specific quantity is stated in the agreement. Determining the tax consequences involves a complex and fact-specific analysis.

This issue drew particular attention in 2009 when newspaper reports revealed a long-running dispute between Lowe's and the Department of Revenue on the application of the law in this area. The report indicated that Lowe's was not collecting sales tax when it sold and subsequently installed items such as cabinets, flooring, and countertops. The Department's position is that these transactions are retail sales plus installation and that Lowe's should be collecting sales tax on the purchases but not the installation charges as long as those charges are separately stated on the customer's invoice. Lowe's position is that the transaction is a performance contract and, therefore, they are only required to pay the use tax because they are the user or consumer of that property and then that cost is factored into the "contract price" ultimately paid by the

customer, but it is not a separately stated cost. While this particular taxpayer dispute was not discussed at the meeting, largely because of taxpayer confidentiality, many members are aware that the need for clarification is due, in part, because of this dispute.

While the Department identified several possible options for the Committee to consider, including subjecting all or most services to sales and use tax, it did not have a specific recommendation. It would, however, like to see clarification in this area, especially with regard to the types of transactions that are the most problematic. The Committee did not make a recommendation on this issue, but noted that expansion of the sales tax base to include services, which would address this problem, may be discussed in the near future in the context of broader tax modernization efforts.

EXTENSION OF CERTAIN TAX PROVISIONS

At the April 11, 2012 the Committee considered a list of tax provisions that are set to expire in the next three years. The Committee anticipates comprehensive tax modernization in the 2013 session of the General Assembly. In anticipation of potential tax modernization, the Committee chose to maintain the current state of the tax code through 2014. To maintain the current state of the tax code, Legislative Proposal #3 would extend the tier one designation for seafood industrial parks and the following income tax credits and sales tax refunds:

Income Tax Credits:

- Work opportunity tax credit.
- Tax credit for constructing renewable fuel facilities.
- Tax credit for biodiesel producers.
- Article 3J tax credits.
- Tax credit for qualified business ventures.
- Tax credit for recycling oyster shells.

- Tax credit for premiums paid on long-term care insurance.
- Refundable earned income tax credit.
- Tax credit for adoption expenses.

Sales Tax Refunds:

- Passenger air carriers.
- Machinery and equipment placed in a tier one county.
- Aviation fuel of motorsports team or sanctioning body.
- Analytical services business.
- Certain industrial facilities.

REAL ESTATE APPRAISAL MANAGEMENT COMPANIES

At its April 11, 2012 meeting, the Committee considered whether out-of-state real estate appraisal management companies operating in the State are properly filing North Carolina tax returns. These appraisal management companies supervise a network of licensed appraisers who are independent contractors. Federal regulations adopted in response to the housing crisis led to the growth of appraisal management companies. The appraisal management companies are intended to increase the quality and reliability of appraisals to prevent another housing crisis.

The State began to regulate appraisal management companies in S.L. 2010-141 enacting Article 2 in Chapter 93E. This Article authorizes the North Carolina Appraisal Board (Board) to regulate appraisal management companies and requires the companies to register with the Board.

The Board has approximately 140 registered appraisal management companies. Only 6 of the 140 are North Carolina companies. The out-of-state companies owe State income tax on the appraisal work conducted within the State. The current registration

form requires appraisal management companies to disclose information that would allow the Department of Revenue to determine whether the companies are properly filing State income tax returns.

Legislative Proposal #4 would require the Board to report annually to the Department of Revenue the following information about registered appraisal management companies: name, address, process agent if any, type of entity, employer identification number or social security number, and North Carolina Secretary of State identification number if any. The information required by the Legislative Proposal is currently disclosed when an appraisal management company registers. The Department of Revenue could use the information from the Board to check the filing status of registered appraisal management companies.

REVENUE LAWS TECHNICAL, CLARIFYING, AND ADMINISTRATIVE CHANGES

The Revenue Laws Study Committee recommends Legislative Proposal #5, Revenue Laws Technical, Administrative, and Clarifying Changes. This proposal makes several technical and clarifying changes to the revenue laws and related statutes. Many of the changes were recommendations of the Department of Revenue, including several changes related to the combined motor vehicle registration and property tax system which goes into effect July 1, 2013.

COMMITTEE RECOMMENDATIONS AND LEGISLATIVE PROPOSALS

The Revenue Laws Study Committee makes the following five recommendations to the 2012 General Assembly. Each proposal is followed by an explanation and, if it has a fiscal impact, a fiscal memorandum, indicating any anticipated revenue gain or loss resulting from the proposal.

1. Expedited Rulemaking for Forced Combination
2. Unemployment Insurance Changes
3. Extend Tax Provisions
4. Appraisal Management Companies Reported to Department of Revenue
5. Revenue Laws Technical, Clarifying, and Administrative Changes

LEGISLATIVE PROPOSAL #1

EXPEDITED RULEMAKING FOR FORCED COMBINATION

LEGISLATIVE PROPOSAL #1

A RECOMMENDATION OF THE REVENUE LAWS STUDY COMMITTEE
TO THE 2012 REGULAR SESSION OF THE 2011 GENERAL ASSEMBLY

AN ACT TO REQUIRE THE SECRETARY OF REVENUE'S INTERPRETATION OF THE LAW CONCERNING THE SECRETARY'S AUTHORITY TO ADJUST NET INCOME OR REQUIRE A COMBINED RETURN BE MADE THROUGH RULEMAKING AND TO PROVIDE AN EXPEDITED PROCESS FOR RULEMAKING ON THIS ISSUE.

SHORT TITLE: Expedited Rulemaking for Forced Combination.

PRIMARY SPONSORS:

BRIEF OVERVIEW: This Legislative Proposal would require the Department of Revenue to adopt rules regarding its interpretation of G.S. 105-130.5A, the Secretary's authority to re-determine the State net income of a corporation properly attributable to its business carried on in the State by adjusting its net income or requiring it to file a combined return. The proposal provides an expedited rule-making process for these rules.

FISCAL IMPACT:

EFFECTIVE DATE: This proposal would become effective when it becomes law.

A copy of the proposed legislation, a bill analysis, and fiscal analysis begin on the next page.

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LEGISLATIVE PROPOSAL #2

UNEMPLOYMENT INSURANCE CHANGES

LEGISLATIVE PROPOSAL #2

A RECOMMENDATION OF THE REVENUE LAWS STUDY COMMITTEE
TO THE 2012 REGULAR SESSION OF THE 2011 GENERAL ASSEMBLY

AN ACT TO MAKE CHANGES TO THE UNEMPLOYMENT INSURANCE LAWS.

SHORT TITLE: Unemployment Insurance Changes

PRIMARY SPONSORS:

BRIEF OVERVIEW: This Legislative Proposal includes several changes to the unemployment laws that fall within these three categories:

- The extension of the three-year look-back period from January 1, 2012 to January 1, 2013.
- The resolution of outstanding issues associated with S.L. 2011-401, Senate Bill 532.
- The statutory changes required to comply with the federal Trade Adjustment Assistance Extension Act of 2011.

FISCAL IMPACT:

EFFECTIVE DATE: Except as otherwise provided, this act becomes effective when it becomes law.

A copy of the proposed legislation and a bill analysis begin on the next page.

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LEGISLATIVE PROPOSAL #3

EXTEND TAX PROVISIONS

LEGISLATIVE PROPOSAL #3

A RECOMMENDATION OF THE REVENUE LAWS STUDY COMMITTEE
TO THE 2012 REGULAR SESSION OF THE 2011 GENERAL ASSEMBLY

AN ACT TO EXTEND THE SUNSET OF CERTAIN TAX PROVISIONS AS PROPOSED BY THE REVENUE LAWS STUDY COMMITTEE

SHORT TITLE: Extend Tax Provisions.

PRIMARY SPONSORS:

BRIEF OVERVIEW: This Legislative Proposal would extend the sunset of certain tax provisions as proposed by the Revenue Laws Study Committee.

FISCAL IMPACT:

EFFECTIVE DATE: This act would become effective when it becomes law.

A copy of the proposed legislation and a bill analysis begin on the next page.

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LEGISLATIVE PROPOSAL #4

APPRAISAL MANAGEMENT COMPANIES REPORTED TO DEPARTMENT OF REVENUE

LEGISLATIVE PROPOSAL #4

A RECOMMENDATION OF THE REVENUE LAWS STUDY COMMITTEE
TO THE 2012 REGULAR SESSION OF THE 2011 GENERAL ASSEMBLY

AN ACT TO REQUIRE THE NORTH CAROLINA APPRAISAL BOARD TO REPORT THE RECORDS OF APPRAISAL MANAGEMENT COMPANIES TO THE NORTH CAROLINA DEPARTMENT OF REVENUE

SHORT TITLE: Appraisal Management Company Reported to Department of Revenue.

PRIMARY SPONSORS:

BRIEF OVERVIEW: This Legislative Proposal would require the North Carolina Appraisal Board to report annually to the North Carolina Department of Revenue the following information about registered appraisal management companies: name, address, process agent if any, type of entity, employer identification number or social security number, and North Carolina Secretary of State identification number if any.

FISCAL IMPACT:

EFFECTIVE DATE: This act would become effective December 1, 2012.

A copy of the proposed legislation and a bill analysis begin on the next page.

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LEGISLATIVE PROPOSAL #5

REVENUE LAWS TECHNICAL, CLARIFYING, AND ADMINISTRATIVE CHANGES

LEGISLATIVE PROPOSAL #5

A RECOMMENDATION OF THE REVENUE LAWS STUDY COMMITTEE
TO THE 2012 REGULAR SESSION OF THE 2011 GENERAL ASSEMBLY

AN ACT TO MAKE TECHNICAL, CLARIFYING, AND ADMINISTRATIVE CHANGES TO THE TAX AND RELATED LAWS

SHORT TITLE: Revenue Laws Technical, Clarifying, and Administrative Changes

PRIMARY SPONSORS:

BRIEF OVERVIEW: This Legislative Proposal would make technical, clarifying, and administrative changes to the revenue laws and related statutes, many of which were requested by the Department of Revenue.

FISCAL IMPACT:

EFFECTIVE DATE: Except as otherwise provided, this act would become effective when it becomes law.

A copy of the proposed legislation and a bill analysis begin on the next page.

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APPENDIX A

AUTHORIZING LEGISLATION
ARTICLE 12L OF CHAPTER 120
OF THE
GENERAL STATUTES

ALL MATERIALS DISTRIBUTED AT MEETINGS MAY BE VIEWED ON THE COMMITTEE'S WEBSITE:
http://www.ncleg.net/committees/revenuelaws

ARTICLE 12L

Revenue Laws Study Committee

§ 120-70.105. Creation and membership of the Revenue Laws Study Committee.

(a) Membership. – The Revenue Laws Study Committee is established. The Committee consists of 20 members as follows:

(1) Ten members appointed by the President Pro Tempore of the Senate; the persons appointed may be members of the Senate or public members.

(2) Ten members appointed by the Speaker of the House of Representatives; the persons appointed may be members of the House of Representatives or public members.

(b) Terms. – Terms on the Committee are for two years and begin on January 15 of each odd-numbered year, except the terms of the initial members, which begin on appointment. Legislative members may complete a term of service on the Committee even if they do not seek reelection or are not reelected to the General Assembly, but resignation or removal from service in the General Assembly constitutes resignation or removal from service on the Committee.

A member continues to serve until a successor is appointed. A vacancy shall be filled within 30 days by the officer who made the original appointment. (1997-483, s. 14.1; 1998-98, s. 39; 2009-574, s. 51.1.)

§ 120-70.106. Purpose and powers of Committee.

(a) The Revenue Laws Study Committee may:

(1) Study the revenue laws of North Carolina and the administration of those laws.

(2) Review the State's revenue laws to determine which laws need clarification, technical amendment, repeal, or other change to make the laws concise, intelligible, easy to administer, and equitable.

(3) Call upon the Department of Revenue to cooperate with it in the study of the revenue laws.

(4) Report to the General Assembly at the beginning of each regular session concerning its determinations of needed changes in the State's revenue laws.

These powers, which are enumerated by way of illustration, shall be liberally construed to provide for the maximum review by the Committee of all revenue law matters in this State.

(b) The Committee may make interim reports to the General Assembly on matters for which it may report to a regular session of the General Assembly. A report to the General Assembly may contain any legislation needed to implement a recommendation of the Committee. When a recommendation of the Committee, if enacted, would result in an increase or decrease in State revenues, the report of the Committee must include an estimate of the amount of the increase or decrease.

(c) The Revenue Laws Study Committee must review the effect Article 42 of Chapter 66 of the General Statutes, as enacted by S.L. 2006-151, has on the issues listed in this section to determine if any changes to the law are needed:

(1) Competition in video programming services.

(2) The number of cable service subscribers, the price of cable service by service tier, and the technology used to deliver the service.

(3) The deployment of broadband in the State.

The Committee must review the impact of this Article on these issues every two years and report its findings to the North Carolina General Assembly. The Committee must make its first report to the 2008 Session of the North Carolina General Assembly. (1997-483, s. 14.1; 2006-151, s. 21.)

§ 120-70.107. Organization of Committee.

(a) The President Pro Tempore of the Senate and the Speaker of the House of Representatives shall each designate a cochair of the Revenue Laws Study Committee. The Committee shall meet upon the joint call of the cochairs.

(b) A quorum of the Committee is nine members. No action may be taken except by a majority vote at a meeting at which a quorum is present. While in the discharge of its official duties, the Committee has the powers of a joint committee under G.S. 120-19 and G.S. 120-19.1 through G.S. 120-19.4.

(c) The Committee shall be funded by the Legislative Services Commission from appropriations made to the General Assembly for that purpose. Members of the Committee receive subsistence and travel expenses as provided in G.S. 120-3.1 and G.S. 138-5. The Committee may contract for consultants or hire employees in accordance with G.S. 120-32.02. Upon approval of the Legislative Services Commission, the Legislative Services Officer shall assign professional staff to assist the Committee in its work. Upon the direction of the Legislative Services Commission, the Supervisors of Clerks of the Senate and of the House of Representatives shall assign clerical staff to the Committee. The expenses for clerical employees shall be borne by the Committee. (1997-483, s. 14.1.)

APPENDIX B

DISPOSITION OF COMMITTEE'S RECOMMENDATIONS TO THE 2011 REGULAR SESSION OF THE 2011 GENERAL ASSEMBLY

ALL MATERIALS DISTRIBUTED AT MEETINGS MAY BE VIEWED ON THE COMMITTEE'S WEBSITE: http://www.ncleg.net/committees/revenuelaws

DISPOSITION OF REVENUE LAWS STUDY COMMITTEE RECOMMENDATIONS TO THE 2011 REGULAR SESSION OF THE 2011 GENERAL ASSEMBLY

SHORT TITLE	SENATE SPONSORS	HOUSE SPONSORS	BILL #	FINAL STATUS*
IRC Update	**Hartsell Tillman Newton**	**Howard Brubaker Starnes Setzer**	**HB 124 SB 94**	**Enacted* SL 2011-5, [HB 124]**
Business Entity Changes	**Hartsell Clodfelter Tillman**	**Howard Brubaker Luebke Hill**	**HB 123 SB 93**	**Enacted* SL 2011-9, [HB 123]**
Revenue Laws Technical, Clarifying, & Administrative Changes	**Clodfelter Hartsell**	**Howard Luebke Gibson**	**HB 122 SB 267**	**Enacted* SL 2011-330, [SB 267]**

* Bills were modified prior to enactment.

APPENDIX C

MEETING AGENDAS

ALL MATERIALS DISTRIBUTED AT MEETINGS MAY BE VIEWED ON THE COMMITTEE'S WEBSITE:
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REVENUE LAWS STUDY COMMITTEE AGENDA

Rep. Julia Howard ***Rep. Danny McComas*** ***Sen. Bob Rucho***

Wednesday, October 5, 2011
Room 544, Legislative Office Building
9:30 a.m.

I. Welcome and Introduction of Members

II. 2011 Finance Law Changes

- *Trina Griffin and Heather Fennell, Research Division*

III. Introduction to the Machinery Act

- **NC Property Tax Basics**
  Chris McLaughlin, Assistant Professor of Public Law and Government, School of Government
- **Mechanics of the Reappraisal Process**
  David Baker, Director, Local Government Division, Department of Revenue
- **Property Tax Relief Programs**
  Dan Ettefagh, Bill Drafting Division

IV. Implementation of Tax Credit for Children with Special Disabilities and the Shift to Adjusted Gross Income

- *Canaan Huie, General Counsel, Department of Revenue*

V. General Fund Revenue Outlook – September 2011
Barry Boardman, Fiscal Research Division

VI. Adjournment

REVENUE LAWS STUDY COMMITTEE AGENDA

Rep. Julia Howard | ***Rep. Danny McComas*** | ***Sen. Bob Rucho***

Wednesday, November 2, 2011
Room 544, Legislative Office Building
9:30 a.m.

I. Approval of Minutes from the October 5, 2011 Meeting

II. Issues Concerning State's Entrance Into A Multistate Agreement for the Purpose of Carrying Out the Nonadmitted and Reinsurance Reform Act of 2010.

- *Rose Vaughn-Williams, Department of Insurance*

III. Forced Combinations

- **Overview of the Law and Outstanding Issues**
  Jonathan Tart, Fiscal Research Division
- **Comments**
  - *Canaan Huie, Department of Revenue*
  - *Todd Lard, Council on State Taxation (COST)*

V. Adjournment

REVENUE LAWS STUDY COMMITTEE AGENDA

Rep. Julia Howard ***Rep. Danny McComas*** ***Sen. Bob Rucho***

Wednesday, December 7, 2011
Room 544, Legislative Office Building
9:30 a.m.

I. Approval of Minutes from the November 2, 2011 Meeting

II. Financing of Capital Projects
Vance Holloman, Local Government Commission

III. Update on ESC Issues

- **ESC Transfer to Commerce, S.L. 2011-145, Sections 14.5 and 14.5C and S.L. 2011-401**
  The General Assembly transferred the Employment Security Commission to the Department of Commerce as part of the Current Operations and Capital Improvement Act of 2011 and it also authorized Commerce to contract with someone to obtain recommendations to achieve employment security organizational reforms savings.

  Dale Carroll, Deputy Secretary, Department of Commerce

- **Implementation of Reform UI Tax Structure/Expedite Analysis, S.L. 2011-10**
  The General Assembly authorized the Department of Commerce to contract with a consultant to obtain recommendations on how to best achieve Unemployment Trust Fund solvency. Commerce submitted a RFP in October; the period for submitting a proposal to Commerce closed in November.

  Dale Carroll, Deputy Secretary, Department of Commerce

IV. Department of Revenue Directive on Forced Combinations

The General Assembly repealed the Secretary's current statutory authority to require a corporation to file a combined return and replaced it with a new statute that becomes effective January 1, 2012. Under the Secretary's existing authority, a corporation may be required to file a combined return if the Secretary determines its single entity return does not reflect its true earnings in this State. Under the new authority, a corporation may be required to file a combined return if the Secretary determines the corporation's intercompany transactions lack economic substance or are not at fair market value.

The Department of Revenue released a technical bulletin on November 16, 2011. A copy of the directive is included with the meeting materials. The bulletin gives the Department's interpretation of the law change made in S.L. 2011-390.

Canaan Huie, General Counsel, Department of Revenue

V. General Fund Revenue Outlook

Barry Boardman, Fiscal Research Division

VI. Adjournment

REVENUE LAWS STUDY COMMITTEE AGENDA

Rep. Julia Howard ***Rep. Danny McComas*** ***Sen. Bob Rucho***

Wednesday, January 4, 2012
Room 544, Legislative Office Building
9:30 a.m.

I. Approval of Minutes from the December 7, 2011 Meeting

II. The North Carolina Estate Tax

- **Overview**
  Greg Roney, Research Division
- **Comment**
  Dick Patten, President, American Family Business Institute

III. Update on ESC Issues

- *Lynn Holmes, Assistant Secretary, Division of Employment Security*

IV. Adjournment

REVENUE LAWS STUDY COMMITTEE AGENDA

Rep. Julia Howard ***Rep. Danny McComas*** ***Sen. Bob Rucho***

Wednesday, February 1, 2012
Room 544, Legislative Office Building
9:30 a.m.

I. Approval of Minutes from the January 4, 2011 Meeting

II. Local Privilege License Tax Authority

- *Christopher McLaughlin, Assistant Professor of Public Law and Government, UNC School of Government*
- *Andy Ellen, President and General Counsel, NC Retail Merchants' Association*
- *Jim Ahler, Executive Director, NC Association of CPAs*

III. Property Tax Valuation of Business Personal Property

- *Ken Joyner, Lecturer in Public Finance and Government, UNC School of Government*
- *Mack McLamb, Manager, Carlie C's grocery store*
  Jason Wenzel, Counsel, Narron, O'Hale, and Whittington, P.A.
- *David Baker, Director, Local Government Division, Department of Revenue*

IV. Property Tax Appeals Process

- *Cindy Avrette, Research Division*
- *Pat Goddard, Johnston County Tax Assessor*
- *David Baker, Director, Local Government Division, Department of Revenue*

V. Repeal North Carolina Estate Tax

- *Legislative Proposal, Jonathan Tart, Fiscal Research Division*
- *Edwin McLenaghan, Public Policy Analyst, NC Budget & Tax Center*
- David Heinen, Director of Public Policy and Advocacy, N.C. Center for Nonprofits

VI. Adjournment

REVENUE LAWS STUDY COMMITTEE AGENDA

Rep. Julia Howard ***Rep. Danny McComas*** ***Sen. Bob Rucho***

Wednesday, March 7, 2012
Room 544, Legislative Office Building
9:30 a.m.

I. Approval of Minutes from the February 1, 2012, Meeting

II. Sales Tax Application Issues:

A. Taxation of Solar Electricity Generating Equipment
Canaan Huie, General Counsel, Department of Revenue

B. Sales Tax and Performance Contracts
Canaan Huie, General Counsel, Department of Revenue

III. Interpretation of Revenue Laws by Secretary of Revenue

- Greg Roney, Legislative Analyst, Research Division
- Chuck Neely, Williams & Mullens, COST
- Andy Ellen, NC Retail Merchant's Association
- Canaan Huie, General Counsel, Department of Revenue

IV. Repeal State Estate Tax

- Jonathan Tart, Fiscal Analyst, Fiscal Research Division
- Alexandra Sirota, NC Budget & Tax Center
- Brian Balfour, John W. Pope Civitas Institute
- David Heinen, NC Center for Nonprofits

V. General Fund Revenue Update
Barry Boardman, Economist, Fiscal Research Division

VI. Adjournment

REVENUE LAWS STUDY COMMITTEE AGENDA

Rep. Julia Howard ***Rep. Danny McComas*** ***Sen. Bob Rucho***

Wednesday, April 11, 2012
Room 544, Legislative Office Building
9:30 a.m.

I. **Approval of Minutes from the March 7, 2012, Meeting**

II. **Interpretation of G.S. 105-130.5A by Secretary of Revenue: *The Issue of Forced Combinations and Guidelines***
Cindy Avrette, Research Division, NCGA

III. **Extension of Tax Provision: Work Opportunity Tax Credit**
Heather Fennell, Research Division, NCGA

IV. **Collection of NC Income Tax from Out-of-State Real Estate Appraisal Management Companies**
Jonathan Tart, Fiscal Research Division, NCGA

V. **2012 Technical and Administrative Changes Bill**
Trina Griffin, Research Division, NCGA

V. **Adjournment**

REVENUE LAWS STUDY COMMITTEE AGENDA

Rep. Julia Howard *Rep. Danny McComas* *Sen. Bob Rucho*

Wednesday, May 2, 2012
Room 544, Legislative Office Building
9:30 a.m.